

Internal Revenue Service

Department of the Treasury

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Washington, DC 20224

Person to Contact:

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Legend

- X =
- A =
- B =
- C =
- D =
- E =
- F =
- Trust 1 =
- Trust 2 =
- Trust 3 =
- Trust 4 =
- Trust 5 =
- Trust 6 =

Trust 7 =
Trust 8 =
Date 1 =
Date 2 =
Date 3 =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
a =
b =
State =

Dear :

This is in reply to a letter, dated December 26, 2001, submitted on behalf of X requesting a ruling under §1362(f) of the Internal Revenue Code.

Facts

The information submitted states that X is an S corporation that was incorporated in Year 1. On Date 1, the only shareholders of X were A and B. On Date 1, A, as settlor, created Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, and Trust 8 (the "Trusts") for the benefit of his grandchildren. On Date 2, A transferred a shares of X stock to each of the Trusts and to C, D, E, and F (the "Children"). On Date 3, A transferred b shares of X stock to each of the Trusts and to each of the Children. A used language in each of the Trusts that intended to qualify each Trust as a "qualified subchapter S trust" ("QSST") under §1361(d). However, due to an oversight, the beneficiaries of the Trusts failed to file the elections required under §1361(d)(2).

The Trusts and the Children were members of a limited liability company that was classified as a partnership for federal tax purposes (the "LLC"). The Trusts and

the Children intended to immediately transfer their shares of X stock to the LLC, which already held various other assets. However, Taxpayer represents that neither the Trusts nor the Children made valid transfers of X stock to the LLC under applicable State law. Even though neither the Trusts nor the Children made valid transfers of X stock to the LLC, all separately stated and non-separately computed items of X attributable to the stock held by the Trusts and the Children were passed through to the LLC on X's income tax returns for Year 2 through Year 3.

X represents that the transfer of X stock to the Trusts, the subsequent failure to file QSST elections, and the treatment of the LLC as a shareholder of X were not motivated by tax avoidance or retroactive tax planning. For all taxable years, all taxable income of the Trusts has been reported consistent with the Trusts being treated as QSSTs. X and X's shareholders agree to make any adjustments (consistent with the treatment of X as an S corporation) that the Secretary may require.

Law and Analysis

Section 1361(a)(1) of the Internal Revenue Code defines an "S corporation" means, as a small business corporation for which an election under §1362(a) is in effect for the taxable year .

Section 1361(b)(1)(B) provides that the term "small business corporation" is a domestic corporation which is not an ineligible corporation and which does not have as a shareholder a person (other than an estate and other than a trust described in §1361(c)(2) or an organization described in §1361(c)(6)) who is not an individual.

Section 1361(d)(1) provides that in the case of a QSST with respect to which a beneficiary makes an election under §1361(d)(2), such trust shall be treated as a trust described in §1361(c)(2)(A)(i) and, for purposes of §678(a), the beneficiary of such trust shall be treated as the owner of that portion of the trust which consists of stock in an S corporation with respect to which the election under §1361(d)(2) is made.

Section 1361(d)(2) provides that a beneficiary of a QSST (or his legal representative) may elect to have §1361(d) apply. Section 1362(d)(2)(D) provides that an election under §1361(d)(2) shall be effective up to 15 days and 2 months before the date of the election.

Section 1.1361-1(j)(6)(ii) of the Income Tax Regulations provides that the current income beneficiary of the trust must make the election under §1361(d)(2) by signing and filing with the service center, with which the corporation files its income tax return the applicable form or a statement including the information listed in §1.1361-1(j)(6)(ii).

Section 1362(d)(2) provides that an election under §1362(a) shall be terminated whenever (at any time on or after the first day of the taxable year for which a

corporation is an S corporation) such corporation ceases to be a small business corporation. A termination of an S corporation election under §1362(d)(2) is effective on and after the date of cessation.

Section 1362(f) provides that if (1) an election under §1362(a) by any corporation (A) was not effective for the taxable year for which made (determined without regard to §1362(b)(2)) by reason of a failure to meet the requirements of §1361(b) or to obtain shareholder consents, or (B) was terminated under paragraph (2) or (3) of §1362(d), (2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent, (3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken (A) so that the corporation is a small business corporation, or (B) to acquire the required shareholder consents, and (4) the corporation, and each person was a shareholder of the corporation at any time during the period specified pursuant to §1362(f), agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in such ineffectiveness or termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

Conclusion

Based solely on the facts submitted and the representations made, we conclude that X's S election was terminated on Date 2, when the Trusts first acquired X stock. We also conclude that this termination was inadvertent within the meaning of §1362(f). Under the provisions of §1362(f), X will be treated as continuing to be an S corporation from Date 2, and thereafter, provided that X's S election was valid and was not otherwise terminated under §1362(d). Accordingly, all of the shareholders in X, in determining their respective income tax liabilities for the period beginning Date 2 and thereafter, must include their pro rata share of the separately stated and non-separately computed items of X as provided in §1366, make any adjustments to basis provided in §1367, and take into account any distributions made by X as provided in §1368. For purposes of the preceding sentence (1) for all years beginning with Year 2 and ending with Year 3, the LLC must be treated as if it owned the X stock held by Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, Trust 8, C, D, E, and F; and (2) for Year 4 and thereafter, Trust 1, Trust 2, Trust 3, Trust 4, Trust 5, Trust 6, Trust 7, Trust 8, C, D, E, and F must be treated as owning as many shares of X stock as each Trust or individual actually holds. If X or its shareholders fail to treat themselves as described above, this ruling shall be null and void.

Furthermore, this ruling is contingent on the beneficiaries of all of the Trusts making QSST elections, effective Date 2, with the appropriate service center within 60 days of the date of this letter, and attaching a copy of this letter to the elections.

Except as specifically ruled upon above, we express no opinion concerning the

Federal tax consequences of the transactions described above under any other provisions of the Code. Specifically, no opinion is expressed on whether X is otherwise eligible to be treated as an S corporation or whether the Trusts are eligible to be QSSTs.

This ruling is directed only to the taxpayer who requested it. Section §6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Pursuant to the power of attorney on file with this office, a copy of this letter is being sent to X's authorized representative.

Sincerely,
Matthew Lay
Acting Chief, Branch 2
Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures: (2)
Copy of this letter
Copy for § 6110 purposes